

Message Text

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FM AMEMBASSY LIMA

TO SECSTATE WASHDC 1815

INFO AMEMBASSY BRASILIA

AMEMBASSY LA PAZ

AMEMBASSY QUITO

AMEMBASSY SANTIAGO

USCINCSO QUARRY HTS CZ

C O N F I D E N T I A L SECTION 1 OF 3 LIMA 7508

E.O. 11652: GDS

TAGS: EGEN, ETRD, EMIN, ENRG, PE

SUBJECT: ECONOMIC CONSTRAINTS ON PERU'S "REVOLUTION"

REF: LIMA 6692

1. SUMMARY: AFTER SEVERAL YEARS OF SATISFACTORY GROWTH WITH FEW SERIOUS PROBLEMS, PERU'S ECONOMICS PROSPECTS HAVE RECENTLY DECLINED SOMEWHAT AS A RESULT OF ADVERSE DEVELOPMENTS IN INTERNATIONAL FINANCIAL AND COMMODITY MARKETS. AT THE SAME TIME, THE CONTINUED POOR PERFORMANCE BY THE AGRICULTURAL SECTOR AND THE SUSTAINED LACK OF INVESTMENT BY THE PRIVATE SECTOR HAVE PRODUCED SHORTAGES OF IMPORTANT FOODSTUFFS AND OTHER CONSUMER GOODS THEREBY ADDING TO THE COUNTRY'S BALANCE OF PAYMENTS AND INFLATION PROBLEMS AND GIVING RISE TO INCREASED
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POPULAR DISCONTENT WITH THE CONCOMITANT INCREASED CONCERN

WITHIN THE GOP. THE PRESENT MILITARY GOVERNMENT ENJOYS AN ALMOST UNIVERSAL DISTRUST BY THE PRIVATE SECTOR, HEIGHTENED RECENTLY BY A MORE RADICAL STATEMENT OF GOALS IN "PLAN INCA", WHICH CONTINUES TO SEVERELY LIMIT NEW INVESTMENT. THE ECONOMY IS SUFFERING AS WELL FROM INSUFFICIENT MANAGERIAL AND TECHNICAL CAPACITY, ESPECIALLY IN THE PUBLIC SECTOR, CAUSED PARTIALLY BY INCREASED EMIGRATION OF MANAGERIAL AND PROFESSIONAL PEOPLE. FURTHERMORE, IT IS INCREASINGLY UNLIKELY THAT OIL WILL BE FLOWING THROUGH THE TRANS-ANDEAN PIPELINE BY MID-1976 AS PREVIOUSLY SCHEDULED AND THUS THE PERIOD DURING WHICH THE GOVERNMENT'S DEVELOPMENT PLANS AND PROBLEMS WILL HAVE TO BE COVERED BY EXTERNAL BORROWING IS CORRESPONDINGLY EXTENDED. THE INEPT PERFORMANCE OF FORMER FINANCE MINISTER MARCO DEL PONT DID LITTLE TO BUILD CONFIDENCE IN THE COUNTRY'S ECONOMIC FUTURE. HIS SUCCESSOR, GENERAL VARGAS GAVILANO, AND THE CABINET ARE FACED WITH SOME DIFFICULT DECISIONS CONCERNING RISING IMPORT COSTS; PRICING POLICY FOR BASIC FOODS AND PETROLEUM WHICH ARE CURRENTLY HEAVILY SUBSIDIZED BY THE STATE; AND GROWING LABOR UNREST AND POPULAR DISCONTENT AS REAL WAGES DECREASE AND SHORTAGES OF CONSUMER GOODS BECOME MORE FREQUENT. THE PURPOSE OF THIS TELEGRAM, WHICH SHOULD BE READ AS A COMPANION PIECE TO REFTTEL, IS TO INDICATE PERU'S ECONOMIC PROSPECTS AND TO SPECULATE ON THE RESULTING IMPLICATIONS FOR THE GOVERNMENT'S REVOLUTIONARY REFORMS AND FOR THE STABILITY OF THE MILITARY GOVERNMENT ITSELF. WHILE THE ECONOMIC PRESSURES FACING THE GOP WILL UNDOUBTEDLY TAX PERU'S RESOURCES AND MANAGERIAL ABILITIES, ON BALANCE THE EMBASSY CONCLUDES THAT THE GOVERNMENT WILL NOT FIND IT NECESSARY TO MODIFY THE BASIC DIRECTION OF ITS REFORMS NOR WILL IT ENCOUNTER SUFFICIENT PUBLIC DISCONTENT TO THREATEN THE STABILITY OF THE GOVERNMENT ITSELF. END SUMMARY

2. RECENT DEVELOPMENTS IN INTERNATIONAL FINANCIAL AND COMMODITY MARKETS ARE SERIOUSLY AFFECTING PERU'S BUDGETARY AND BALANCE OF PAYMENTS SITUATION, ADDING TO THE CONTINUING PROBLEMS RESULTING FROM DECLINING PER CAPITA PRODUCTION OF BASIC FOOD-STUFFS AND FROM A SUSTAINED LACK OF PRIVATE DOMESTIC INVESTMENT. FOLLOWING ARE DISCUSSIONS OF THESE FACTORS AND THEIR PROBABLE FUTURE EFFECTS.

3. RESTRICTIONS ON THE PRIVATE SECTOR: PROMULGATION OF THE CONFIDENTIAL

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SOCIAL PROPERTY LAW, GIVING LARGE COMPETITIVE ADVANTAGE TO FIRMS IN THIS NEW SECTOR, HAS DEALT YET ANOTHER BLOW TO THE FUTURE PROSPECTS OF THE PRIVATE SECTOR WHILE FURTHER CONCERN HAS BEEN CAUSED BY REVELATION OF "PLAN INCA" WHICH CALLS FOR PROGRESSIVE REDUCTION IN THE ROLE OF PRIVATE ENTERPRISE IN ALL SECTORS OF ECONOMIC ACTIVITY, INCLUDING PETROLEUM, MINING, BANKING, INSURANCE, MEDICINE AND OTHER SECTORS HERETOFORE RELATIVELY UNTOUCHED BY THE REVOLUTION, NOTWITHSTANDING

PRESIDENT VELASCO'S RELATIVELY CONCILIATORY STATEMENTS RE THESE SECTORS IN HIS PRESS CONFERENCE OF SEPTEMBER 4. (SEE SEPTTEL.) EVEN PRIOR TO THESE RECENT DEVELOPMENTS, NEW PRIVATE INVESTMENT HAD ALMOST COMPLETELY STOPPED DUE TO LEGISLATION GRADUALLY REQUIRING 50 PERCENT WORKER OWNERSHIP AND CO-MANAGEMENT OF ALL INDUSTRIAL FIRMS, ALTHOUGH CONSIDERABLE REINVESTMENT HAS BEEN OCCURRING TO TAKE ADVANTAGE OF THE LARGE TAX INCENTIVES AVAILABLE. AS A RESULT, THE INDUSTRIAL BASE OF THE COUNTRY IS EXPANDING SLOWLY, PRODUCTION COSTS ARE INCREASING RAPIDLY, AND FEW NEW JOBS ARE APPEARING IN THE PRIVATE INDUSTRIAL SECTOR. MOREOVER, EXTENSIVE BUREAUCRATIC CONTROL OF ALL ASPECTS OF BUSINESS MANAGEMENT HAS ADDED TO THE FRUSTRATION AND GLOOM OF PRIVATE ENTREPRENEURS. THE GOP RECENTLY ESTABLISHED A HIGH LEVEL COMMISSION TO EXPEDITE THE REQUIRED APPROVAL OF INVESTMENT PLANS, BUT BUSINESS SKEPTICS ASSUME, PROBABLY WITH SOME ACCURACY, THAT THE PROBLEM IS NOT ONE WHICH JUST ONE MORE LEVEL IN THE BUREAUCRATIC MAZE CAN SOLVE. MEANWHILE, RUMORS CONTINUE TO CIRCULATE ABOUT FORTHCOMING MORE RADICAL CHANGES IN THE INDUSTRIAL COMMUNITY (WORKER OWNERSHIP) CONCEPT WHICH WOULD ALLEGEDLY INCREASE THE POWER OF THE COMMUNITIES OVER COMPANY DECISIONS AND REDUCE THE TIME PERIOD IN WHICH THE WORKERS BECOME FULL CO-OWNERS.

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USIA-15 IGA-02 FEA-02 FPC-01 INT-08 L-03 H-03 DRC-01

SWF-02 /207 W

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R 071548Z SEP 74

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AMEMBASSY LA PAZ
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4. AGRARIAN REFORM AND AGRICULTURAL SUBSIDIES: FACED WITH CAMPESINO OPPOSITION TO COOPERATIVIZATION AND STAGNANT AGRICULTURAL PRODUCTION, AT LEAST IN PART DUE TO ITS REFORMS, THE GOP IS NOW REEVALUATING ITS AGRARIAN REFORM PROGRAM. MOREOVER, LARGE AMOUNTS OF EXPROPRIATED LAND LIE IDLE AWAITING COMPLETION OF THE ADJUDICATION PROCESS. PEASANT AND SMALL LAND OWNER DISCONTENT WITH THE REFORM SMOLDERS IN RURAL AREAS, WHILE THE PER CAPITA PRODUCTION OF MOST BASIC FOOD PRODUCTS CONTINUES TO DECLINE WITH CONSEQUENT PERIODIC SHORTAGES OF FOOD GIVING RISE TO INCREASINGLY VOCAL URBAN DISCONTENT. ALSO, THE INEVITABLE PRICE INCREASES AND RISING FOOD IMPORTS ARE CONTRIBUTING SIGNIFICANTLY TO THE BUDGETARY DEFICIT, INFLATION AND TO THE BALANCE OF PAYMENTS PROBLEM. THUS FAR, THESE DIFFICULTIES ARE NEITHER WIDESPREAD NOR SERIOUS ENOUGH TO PRODUCE ORGANIZED OR EVEN SPONTANEOUS VIOLENCE. NONETHELESS, CONFIDENTIAL

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PRESIDENT VELASCO'S CONCERN IS EVIDENT IN HIS DESIRE TO CONTINUE SUBSIDIZING MASS CONSUMPTION FOOD ITEMS AND HIS ATTRIBUTING THE SHORTAGES TO "COUNTERREVOLUTIONARIES", THEREBY AVOIDING REQUISITE PRICE INCREASES. IDEOLOGICALLY, WHILE THE IMPLEMENTATION OF A SYSTEM OF STATE-CONTROLLED CO-OPERATIVES PROCEEDS APACE, THESE PROBLEMS WILL CONTINUE TO DELAY FULL IMPLEMENTATION OF THE AGRARIAN REFORM. MEANWHILE, THE SUBSIDIES ON WHEAT AND OTHER ITEMS CONTINUE TO PLACE A SUBSTANTIAL BURDEN ON THE GOP BUDGET AND ARE LIKELY TO FORCE THE GOP TO AT LEAST CONSIDER THE POLITICALLY UNPALATABLE CHOICE OF UPWARD PRICE ADJUSTMENTS. SUCH ADJUSTMENTS WOULD SIMULTANEOUSLY REDUCE THE BUDGET DEFICIT AND ACT AS A STIMULUS TO GREATER PRODUCTION ASSUMING THEY REACH THE FARMER, BUT WOULD ALSO OF COURSE PASS THE COST ON TO THE CONSUMER, WITH INFLATIONARY CONSEQUENCES ON THE OTHER SIDE OF THE EQUATION. THUS, THE GOP CONTINUES TO FACE A DILEMMA IN REGARD TO AGRICULTURAL SUBSIDIES THAT, EVEN IN THE SHORT RUN, CANNOT CONVENIENTLY BE IGNORED.

5. BALANCE OF PAYMENTS PROSPECTS: DECLINING TERMS OF TRADE AND HIGH INTERNATIONAL INTEREST RATES ARE ADVERSELY AFFECTING PERU'S BOP PROSPECTS. GROWING IMPORTS OF MORE COSTLY WHEAT, FEEDGRAINS, VEGETABLE OILS, AND PETROLEUM WILL MORE THAN OFFSET GREATER EXPORT PROCEEDS FLOWING FROM HIGHER MINERAL PRICES AND PARTIAL RECOVERY OF FISHMEAL EXPORTS, PROBABLY PRODUCING A MODERATE TRADE DEFICIT. MOREOVER, PERU'S ACCESS TO COMMERCIAL CREDITS MAY BE RESTRICTED IN COMING MONTHS AS

INTERNATIONAL CREDIT CONDITIONS TIGHTEN, WHILE THE RESULTING HIGH INTEREST RATES WILL INCREASE THE COUNTRY'S DEBT SERVICE PAYMENTS AND PROBABLY DETER LOAN DRAWDOWNS. THEREFORE, THE POSSIBILITY OF RELATIVELY EASY FINANCING OF INTERIM BOP DEFICITS HAS DECLINED. APPROXIMATELY ONE-HALF OF THE \$600 PLUS MILLION OF EXTERNAL FINANCING REQUIRED FOR THE CONSTRUCTION OF THE TRANS-ANDEAN PIPELINE APPEARS COMMITTED TO PERU BY FOREIGN SOURCES (SEE LIMA 7416) AND REPORTEDLY \$100 MILLION WILL BE EXPENDED ON INITIAL PURCHASES AND PREPARATORY WORK DURING 1974. IT APPEARS MOST UNLIKELY, HOWEVER, THAT THE PIPELINE WILL BE COMPLETED BY THE PUBLICLY-PROCLAIMED TARGET DATE OF JULY 1976. RATHER, MOST SEASONED OBSERVERS BELIEVE THAT THE LINE CANNOT BE FINISHED, EVEN UNDER THE BEST OF CIRCUMSTANCES, UNTIL 1977 OR 1978. CONSTRUCTION CONTRACTS WERE LET ONLY RECENTLY AND THE FIRST PIPE ARRIVED BUT LAST

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WEEK. CONSTRUCTION IS EXPECTED TO TAKE A MINIMUM OF TWO YEARS ONCE THE ACTUAL WORK BEGINS. FURTHER, AND UNDERLYING THE PROBLEMS THE GOP HAS HAD IN PUTTING TOGETHER ITS FINANCING PACKAGE, THERE REMAINS THE CRUCIAL QUESTION OF THE ACTUAL AMOUNT OF PROVEN OIL RESERVES. GOP SPOKESMEN SPEAK GLOWINGLY OF BILLIONS OF BARRELS, BUT PROVEN RESERVES WILL NOT BE KNOWN UNTIL NEXT YEAR WHEN THE COMPANIES PRESENTLY DRILLING ACTUALLY COMPLETE THEIR EXPLORATORY WORK. MOST OBSERVERS BELIEVE THAT SUFFICIENT OIL EXISTS TO JUSTIFY THE INITIAL CONSTRUCTION OF THE BASIC TRANS-ANDEAN LINE (PARTICULARLY AT PRESENT PRICES), BUT THEIR OPTIMISM IS TEMPERED WITH THE KNOWLEDGE THAT CONSIDERABLE ADDITIONAL EXPLORATORY DRILLING MUST BE COMPLETED BEFORE ONE CAN BE CERTAIN. ASIDE FROM THESE NEGATIVE FACTORS, THERE ARE POSITIVE ITEMS ON THE LEDGER AS WELL. THE CUAJONE COPPER PROJECT IS MOVING AHEAD AND WILL BE SIGNED WITHIN A FEW DAYS. NOTWITHSTANDING GENUINE CONCERN OVER THE LONGER RANGE IMPLICATIONS FOR FOREIGN EXPLORATION COMPANIES WHICH AROSE OUT OF VELASCO'S JULY 28 ADDRESS, FOREIGN INVESTMENT IN JUNGLE OIL EXPLORATION WILL REACH \$150 MILLION IN 1974. ALSO, PERU'S INTERNATIONAL CREDIT RATING REMAINS HIGH AND WILL PROBABLY CONTINUE SO UNLESS AN UNFORESEEN DEBACLE OCCURS TO SHAKE CREDITORS' CONFIDENCE. PRESSURE ON THE BOP FIGURED LARGE IN SPECULATION OVER THE RESIGNATION OF FORMER FINANCE MINISTER MARCO DEL PONT WHOSE ILL-CONCEIVED RESTRICTION ON PRIVATE SECTORS IMPORTS IN MAY ALARMED PRIVATE ENTERPRENEURS AND WILL PROBABLY PRODUCE TEMPORARY SHORTAGES IN A WIDE VARIETY OF IMPORTED ITEMS FOR A FEW MONTHS. THE NEW MINISTER HAS PARTIALLY RESCINDED THESE MEASURES, BUT PRIVATE SECTOR IMPORTS REMAIN SUBJECT TO STRICT CONTROLS. OVERALL, THE BOP SHOULD RESULT IN MODERATE DEFICITS FOR BOTH 1974 AND 1975, PUTTING SOME ADDITIONAL PRESSURES ON NET INTERNATIONAL RESERVES WHICH NOW STAND AT AROUND \$300 MILLION. PRESIDENT VELASCO CONTINUES TO RULE OUT DEVALUATION FOR POLITICAL REASONS, BUT IN ANY EVENT

DEVALUATION WOULD NOT HELP THE BALANCE OF TRADE VERY MUCH DUE TO THE GENERAL PRICE INELASTICITY OF THE COUNTRY'S EXPORTS AND IMPORTS. MOREOVER, PERU HAS NOT UNDERTAKEN DRAWINGS WITH THE IMF, SO SUBSTANTIAL CREDIT IS AVAILABLE FROM THAT SOURCE.

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USIA-15 IGA-02 FEA-02 FPC-01 INT-08 L-03 H-03 DRC-01

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6. SERIOUS BUDGETARY DEFICIT: INCREASED SUBSIDIES ON WHEAT, FEEDGRAINS, VEGETABLE OILS, ELECTRICITY AND PETROLEUM DERIVATIVES ARE ADDING TO AN ALREADY LARGE BUDGETARY DEFICIT FOR THE BIENNIUM. EXCLUDING PETROLEUM DERIVATIVES, THE TOTAL SUBSIDIES AMOUNT TO AN ESTIMATED \$320 MILLION (OF WHICH APPROXIMATELY \$100 MILLION GOES TO SUBSIDIZE IMPORTS), EQUAL TO NEARLY 9 PERCENT OF THE ORIGINAL BUDGETED EXPENDITURES. DATA ARE NOT AVAILABLE TO ESTIMATE THE PETROLEUM SUBSIDY; HOWEVER, PERU'S IMPORTS OF OIL FOR 1974 WILL REACH \$180 MILLION, NEARLY QUADRUPLE THE 1973 VALUE. WHEAT AND VEGETABLE OIL PRICES WERE INCREASED SOMEWHAT EARLIER THIS YEAR, AND PRO-

DUCTION OF THE MOST HEAVILY SUBSIDIZED LOW OCTANE GASOLINE
HAS PRACTICALLY CEASED, THEREBY INCREASING AVERAGE PRICES.

7. RISING INFLATION THE RATE OF INFLATION IS INCREASING
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RAPIDLY, ABOUT 25 PERCENT ON AN ANNUAL BASIS IN 1974, DUE
TO HIGHER IMPORT PRICES, BUDGETARY DEFICITS, SUPPLY SHORTAGES
AND HEDGE BUYING TO AVOID FUTURE PRICE INCREASES. WHILE
RECOGNIZING THE SERIOUSNESS OF THE PROBLEM, GOVERNMENT OFFICIALS
CONSIDER ITS CAUSES TO BE LARGELY EXTERNAL IN ORIGIN AND
THEREFORE OUTSIDE THEIR DIRECT CONTROL. IN AN ATTEMPT TO REDUCE
PRICE INCREASES "COUNTERREVOLUTIONARIES" SPECULATING WITH
COMMODITY PRICES HAVE BEEN PROSECUTED; THE RATE OF MONETARY
EXPANSION HAS BEEN SLOWED SOMEWHAT; AND WAGE INCREASES HAVE
BEEN APPROVED ONLY GRUDGINGLY. THE SIZE OF THE FORTHCOMING
WAGE SETTLEMENT FOR CENTROMIN WORKERS WILL BE AN IMPORTANT
INDICATOR OF WHETHER THE GOP IS WILLING TO RISK A CONFRONTATION
WITH LABOR ON THIS ISSUE.

8. CONCLUSION: AS THE THIRD QUARTER OF 1974 DRAWS TO A CLOSE,
REAL GROWTH OF GNP WILL PROBABLY SLOW TO AROUND 5 PERCENT ON
AN ANNUAL BASIS. PER CAPITA PRODUCTION IN THE AGRICULTURAL
SECTOR WILL CONTINUE TO DECREASE AND GROWTH IN MANUFACTURING
WILL BE AFFECTED BY LACK OF INVESTOR CONFIDENCE AND IMPORT
SHORTAGES. FOREIGN INVESTMENT WILL REMAIN LIMITED TO THE
EXTRACTIVE INDUSTRIES. THE BOP WILL PROBABLY EXPERIENCE MODERATE
TO LARGE DEFICITS FOR BOTH 1974 AND 1975, AND THE GOP WILL
CONTINUE TO RELY HEAVILY ON EXTERNAL BORROWING WHICH MAY BECOME
INCREASINGLY MORE DIFFICULT TO SECURE. BUDGETARY PROBLEMS
WILL PERSIST FOR THE REST OF 1974 AND THE FOLLOWING BIENNIUM,
DESPITE TAX AND PRICE POLICY COUNTERMEASURES WHICH THE GOP
MAY DECIDE TO TAKE IN THE NEAR FUTURE. INFLATION WILL REACH 25-
30 PERCENT OVER THE NEXT YEAR OR SO. MODERATE SALARY INCREASES
WILL BE GRANTED UNDER HEAVY PRESSURE FROM LABOR UNIONS, AND
PUBLIC SECTOR EMPLOYEES, INCLUDING TEACHERS, WILL BE GRANTED
WAGE INCREASES TO ASSURE THEIR CONTINUED ACQUIESCENCE IN THE
REVOLUTIONARY GOALS OF THE GOVERNMENT. THUS, GOVERNMENT AND
LABOR'S RECENT "HONEYMOON" MAY WELL TURN SOUR RESULTING IN
INCREASED LABOR OPPOSITION FROM SOME QUARTERS.

9. NOTWITHSTANDING THESE BUFFETING PRESSURES, HOWEVER, PERU'S
BROAD RESOURCE BASE AND GENERALLY PRUDENT ECONOMIC MANAGEMENT
WILL PROBABLY ENABLE THE COUNTRY TO AVOID SERIOUS ECONOMIC
DISLOCATION, AND TO THEREBY PREVENT POPULAR DISCONTENT OVER
INFLATION, AND PERIODIC FOOD AND OTHER SHORTAGES FROM LEADING
TO ORGANIZED AND/OR WIDESPREAD ATTACKS ON THE GOP. HOWEVER,
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THE GOP MAY WELL BE FACED BEFORE LONG WITH SOME HARD CHOICES
ON QUESTIONS OF SUBSIDIES AND WAGE INCREASES THAT IT HAS SO
FAR BEEN ABLE TO AVOID IN ITS ALMOST SIX YEARS IN POWER.
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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: ECONOMIC REPORTS
Control Number: n/a
Copy: SINGLE
Draft Date: 07 SEP 1974
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: shawdg
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1974LIMA07508
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Film Number: D740249-0576
From: LIMA
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1974/newtext/t19740966/aaaacdoo.tel
Line Count: 392
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION ARA
Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 8
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: n/a
Reference: LIMA 6692
Review Action: RELEASED, APPROVED
Review Authority: shawdg
Review Comment: n/a
Review Content Flags:
Review Date: 09 SEP 2002
Review Event:
Review Exemptions: n/a
Review History: RELEASED <09 SEP 2002 by boyleja>; APPROVED <26 FEB 2003 by shawdg>
Review Markings:

Declassified/Released
US Department of State
EO Systematic Review
30 JUN 2005

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: ECONOMIC CONSTRAINTS ON PERU'S "REVOLUTION"
TAGS: EGEN, ETRD, EMIN, ENRG, PE
To: STATE
Type: TE
Markings: Declassified/Released US Department of State EO Systematic Review 30 JUN 2005